096026

4.27.01

REPORT TO THE CONGRESS

74-0268

096026

Examination Of Financial Statements Of The Federal Home Loan Mortgage Corporation For The Years Ended December 31, 1971 And 1972

B-179312

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-179312

To the Speaker of the House of Representatives
and the President pro tempore of the Senate

This is our report on the examination of the financial statements of the Federal Home Loan Mortgage Corporation for the years ended December 31, 1971 and 1972.

We made our examination pursuant to the Emergency Home Finance Act of 1970 (12 U.S.C. 1452).

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of the Treasury; and the Chairman of the Board of Directors, Federal Home Loan Mortgage Corporation.

Elmer B. Staats

Comptroller General
of the United States

Contents

ABBREVIATIONS

FHA	Federal Housing Administration
GAO	General Accounting Office
GNMA	Government National Mortgage Association
VA	Veterans Administration

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

EXAMINATION OF FINANCIAL STATEMENTS OF THE FEDERAL HOME LOAN MORTGAGE CORPORATION FOR THE YEARS ENDED DECEMBER 31, 1971 AND 1972 1062
B-179312

D I G E S T

WHY THE EXAMINATION WAS MADE

The audit of the Federal Home Loan Mortgage Corporation was performed pursuant to the Emergency Home Finance Act of 1970. The act requires GAO to report its audit results to the Congress.

OPINION ON FINANCIAL STATEMENTS

In GAO's opinion, the Corporation's financial statements present fairly its financial position at December 31, 1971 and 1972, and the results of its operations and the changes in its financial position for the years then ended, in conformity with principles and standards of accounting prescribed by the Comptroller General for executive agencies, applied on a consistent basis. (See p. 9.)

OTHER MATTERS OF INTEREST

This is GAO's first examination of the financial statements of the Corporation. The Corporation is a private corporation created by the Congress on July 24, 1970, under title III of the Emergency Home Finance Act of 1970, to strengthen and further develop the secondary market in residential mortgages.

The Corporation's board of directors is composed of the members of the Federal Home Loan Bank Board who serve in this dual capacity without additional compensation. The Federal home loan banks are the sole owners of Corporation stock which consists of 100,000 shares of nonvoting common stock with a par value of $1,000 per share. (See p. 3.)

The Corporation purchases mortgages and participations in groups of mortgages from members of the Federal Home Loan Bank System and from other financial institutions whose deposits or accounts are federally insured.

At December 31, 1972, the Corporation had invested in $1.7 billion worth of mortgage loans, an increase of $0.8 billion over the December 31, 1971, balance. (See p. 4.)

The Corporation obtains funds by issuing bonds and selling participations in groups of mortgages.

RECOMMENDATIONS OR SUGGESTIONS

This report contains no recommendations or suggestions to the Corporation.

MATTERS FOR CONSIDERATION BY THE CONGRESS

This report informs the Congress of the Corporation's financial condition and operations.

Tear Sheet. Upon removal, the report cover date should be noted hereon.

CHAPTER 1

INTRODUCTION

The Federal Home Loan Mortgage Corporation is a private corporation created by Congress on July 24, 1970, under title III of the Emergency Home Finance Act of 1970, to strengthen and further develop the secondary market in residential mortgages and to thereby increase housing availability. The secondary market in mortgages is the process by which one group of persons or companies buys mortgages from another after the mortgage has been originated.

The Corporation carries out its responsibilities by buying and selling mortgages and participations in mortgages and by implementing innovative ideas to make mortgages more marketable. It purchases mortgages from members of the Federal Home Loan Bank System and from other financial institutions whose deposits or accounts are federally insured.

The Corporation obtains funds by (1) issuing mortgage-backed bonds whose principal and interest are guaranteed by the Government National Mortgage Association (GNMA), (2) selling participations in groups of mortgages, and (3) receiving advances from the Federal home loan banks. Since its inception, the Corporation has issued GNMA-guaranteed bonds worth about $1,513 million, sold participations worth about $475 million, and obtained $300 million in advances from the Federal home loan banks.

The Corporation is authorized by law to issue to the Federal home loan banks nonvoting common stock not exceeding a total of $100 million. At December 31, 1972, stock issued to the banks consisted of 100,000 shares with a par value of $1,000 per share.

The Corporation's board of directors is composed of the members of the Federal Home Loan Bank Board who serve in this dual capacity without additional compensation. (See app. II.)

Its principal office is in Washington, D.C., with 12 regional offices located throughout the United States. (See app. I.) The Washington office is responsible for overall management of mortgage operations, research and development, and accounting policies and procedures. Regional offices are responsible for buying and selling mortgages and participations in groups of mortgages.

CHAPTER 2

MORTGAGE OPERATIONS

The Corporation carries out its secondary market operations through mortgage programs involving (1) the purchase of Federal Housing Administration (FHA) and Veterans Administration (VA) mortgages, conventional mortgages, and participations in groups of conventional mortgages and (2) the sale of participations in groups of Corporation-owned conventional mortgages. These programs resulted in the Corporation's investment in $0.9 billion worth of mortgage loans, net of participation sales, at December 31, 1971, and $1.7 billion at December 31, 1972.

FHA AND VA MORTGAGES

The Corporation purchases FHA and VA mortgages and, also, enters into commitments to purchase future FHA and VA mortgages at fixed prices. The commitment is known as a fixed-price forward commitment and is attractive to lenders because, knowing the price at which the Corporation will purchase their mortgages, they can give builders a firm price not subject to changes in the mortgage market, before construction is started.

The majority of the Corporation's holdings in FHA and VA mortgages are pledged to a trust serving as collateral for GNMA-guaranteed bonds issued by the Corporation. The balances of the Corporation's yearend FHA and VA mortgage holdings and the amount of the holdings pledged to the trust are shown below.

	FHA and VA holdings	Pledged to the trust
	(000,000 omitted)	
Dec. 1970	$ 325	$ 315
Dec. 1971	817	615
Dec. 1972	1,492	1,338

CONVENTIONAL MORTGAGES

The Corporation purchases, for delivery in 60 days, both single-family and multifamily conventional mortgages. It also makes maximum fixed constant commitments to purchase multifamily mortgages to be delivered to the Corporation in 2 years. The maximum fixed constant commitment is a method by which changes in interest rates during the commitment period may be recognized on delivery of the mortgage to the Corporation by extending the maturity date instead of by changing the amount of monthly payments.

The Corporation made its first purchase of conventional mortgages in January 1972 and owned about $144 million worth of conventional mortgages at December 31, 1972.

PARTICIPATION PURCHASES

The Corporation has two programs to purchase up to 85 percent participation, or ownership, in conventional loans. In one program it purchases participations in multifamily loans. In the other program it purchases participations in single-family loans or single-family loans combined with up to 50 percent of the sale amount in multifamily loans.

The seller retains a percentage ownership of the loans and is responsible for collecting the monthly payments and remitting the Corporation's share to the Corporation. The seller profits from the difference between the interest rate on the face of the mortgages and the rate at which he sells the participation to the Corporation. In addition, the seller receives the full amount of interest on the unsold percentage.

The Corporation began purchasing participations in December 1970. The balance of Corporation-owned participations, net of sales, at December 31, 1971, was about $147 million and at December 31, 1972, was about $142 million.

PARTICIPATION SALE CERTIFICATES

The Corporation sells participation sale certificates representing interest in Corporation-owned conventional mortgages. Each certificate represents a percentage ownership of the outstanding principal balance of a group of mortgages. The certificates are sold to investors in multiples of $100,000.

The Corporation guarantees the certificates as to the timely payment of interest and the collection of principal, and the certificate holders look only to the Corporation for remittances. Mortgage prepayments and prepayment charges are also distributed to the certificate holders.

Investment in Corporation participation sale certificates is advantageous to members of the Federal Home Loan Bank System because the certificates are transferable and meet the definition of real property loans for tax and regulatory purposes.

CHAPTER 3

MORTGAGE INNOVATIONS

The Corporation is seeking to implement several innovative ideas to help make mortgages more marketable. Several of these ideas, such as standard documentation, forward commitments, and maximum fixed constant commitments, have already been incorporated into their mortgage programs. Forward commitments and maximum fixed constant commitments were discussed previously.

With regard to standard documentation, the Corporation requires all conventional mortgages it purchases to have uniform loan application, appraisal, and mortgage documents. In creating a standard conventional mortgage that would be attractive to investors, the Corporation examined mortgages, deeds of trust, and promissory notes and enlisted the aid of builders, consumer representatives, political leaders, lenders, title companies, and attorneys. As a result, the Corporation developed standard credit applications, appraisal reports, and mortgage documents including a single-family, short-form mortgage document. These forms allow both lender and borrower to decide major loan terms.

New ideas which the Corporation is currently seeking to implement are a loan-grading system, a futures market, and an automated information system.

FUTURES MARKET AND LOAN-GRADING SYSTEM

A futures market in mortgage commitments is a proposal aimed at taking the money-market risk off the lender. During recent years, rates, including mortgage yields, have fluctuated widely. This situation has been a problem for mortgage lenders and builders because they have to make commitments for fixed rates of interest from 3 months to 24 months in advance of the finalized mortgage. Mortgage yield rates may vary during that time.

By developing a futures market, the risk of yield changes would be shifted from the lender or builder to the speculator through a futures contract--a legal commitment to buy or sell a specific amount of something at a set time and at a set price. Consumers would benefit because builders and lenders would no longer have to take this risk into account when setting their prices. By reducing the risk of adverse interest rate movements, a futures market would stabilize the flow of mortgage financing.

The Corporation is also working on a system of loan grading (for example, good, average, below average) which may be a necessary condition for the development of a futures market. Futures contracts would be written in one grade, but the grade of mortgages delivered would vary and would determine whether premiums are to be paid or discounts are to be received.

The Corporation has been working with private industry and the Government to develop a feasible program for introducing, but not conducting, a futures market. The Corporation will act only as a participant in the market if it becomes operational.

AUTOMATED INFORMATION SYSTEM

A secondary market provides liquidity and stability to the primary market by facilitating the transfer of mortgages from originators to investors. The Corporation believes that an automated information system would greatly enhance the secondary market by making a centralized distribution of market offerings available to both buyers and sellers. Instantaneous market knowledge would bring additional participants into the market, and more participants would mean a greater volume of trades. Mortgages would become more competitive with other money market instruments. A more easily accessible market would increase the marketability of the mortgage instruments.

All interested private system vendors who have or could develop a system meeting the needs of the secondary market process will be able to compete for implementing the automated information system. The Corporation's only involvement would be as a developer of the system and then as a subscriber, listing offerings to buy and sell.

CHAPTER 4

SCOPE OF EXAMINATION

Our examination of the Corporation's financial statements was made in accordance with generally accepted auditing standards and included such tests of the accounting records since the inception of the Corporation and such other auditing procedures as we considered necessary in the circumstances. Our work was performed in Washington, D.C., and at the Pittsburgh and Indianapolis regional offices.

The Corporation employs a firm of certified public accountants to audit its accounts and financial statements to facilitate its issuance of GNMA-guaranteed bonds. The firm's audit does not take the place of our audit. However, we relied to the extent possible on the firm's audit and our audit included observations and tests of their work.

CHAPTER 5

OPINION ON FINANCIAL STATEMENTS

In our opinion, the Corporation's financial statements (schs. 1 through 3) present fairly its financial position at December 31, 1971 and 1972, and the results of its operations and the changes in financial position for the years then ended, in conformity with principles and standards of accounting prescribed by the Comptroller General for executive agencies, applied on a consistent basis.

FEDERAL HOME LOAN MORTGAGE CORPORATION

BALANCE SHEET

DECEMBER 31, 1972 AND 1971

	1972	1971
	(000 omitted)	
ASSETS		
MORTGAGE LOANS, AT UNPAID PRINCIPAL BALANCE (note 1):		
Insured by Federal Housing Administration (FHA) or guaranteed by Veterans Administration (VA) (substantially all pledged) (note 2)	$1,492,305	$ 816,509
Less unamortized discount	51,966	27,567
	1,440,339	788,942
Participations in conventional mortgage loans	141,810	147,062
Conventional mortgage loans	144,038	-
	1,726,187	936,004
Less allowance for possible losses	5,000	2,800
Total mortgage loans	1,721,187	933,204
CASH	1,219	3,031
TEMPORARY CASH INVESTMENTS AT COST WHICH APPROXIMATES MARKET (partially pledged)	29,294	85,220
ACCRUED INTEREST AND OTHER RECEIVABLES	13,470	8,136
CLAIMS AGAINST FHA AND VA, net of allowance for losses of $200,000 for 1972 and $120,000 for 1971	8,984	4,049
UNAMORTIZED DEBT EXPENSE AND OTHER ASSETS (note 1)	3,401	2,353
	$1,777,555	$1,035,993
LIABILITIES AND STOCKHOLDERS' EQUITY		
BONDS AND ADVANCES PAYABLE, including $150,000,000 and $175,000,000 due within 1 year in 1972 and 1971, respectively (note 2)	$1,638,743	$ 915,000
OTHER LIABILITIES (note 3):		
Accrued interest	21,763	9,812
Accounts payable and other accrued expenses	2,096	2,824
Commitment fees (note 1)	47	1,252
	1,662,649	928,888
RESERVE FOR PARTICIPATION SALE CERTIFICATE GUARANTEES (notes 1 and 4)	472	13
STOCKHOLDERS' EQUITY:		
Capital stock, nonvoting, $1,000 par value per share: no maximum authorization, 100,000 shares issued and outstanding	100,000	100,000
Retained earnings	14,434	7,092
	$1,777,555	$1,035,993

The notes on pages 14 through 17 are an integral part of this statement.

SCHEDULE 2

FEDERAL HOME LOAN MORTGAGE CORPORATION

STATEMENT OF INCOME AND RETAINED EARNINGS

FOR THE YEARS ENDED DECEMBER 31, 1972 AND 1971

	1972	1971
	(000 omitted)	
INCOME:		
Mortgage loan interest, net	$100,281	$47,867
Interest on temporary cash investments	10,890	7,844
Other income	1,791	48
Total income	112,962	55,759
EXPENSES:		
Interest on borrowings and related costs	96,129	44,102
Mortgage servicing fees	4,686	1,961
Administrative	4,805	2,794
Total expenses	105,620	48,857
NET INCOME	7,342	6,902
Retained earnings, beginning of period	7,092	190
Retained earnings, end of period	$ 14,434	$ 7,092

The notes on pages 14 through 17 are an integral part of this statement.

FEDERAL HOME LOAN MORTGAGE CORPORATION

STATEMENT OF CHANGES IN FINANCIAL POSITION

FOR THE YEARS ENDED DECEMBER 31, 1972 AND 1971

	1972	1971
	(000 omitted)	
FUNDS PROVIDED:		
Net income	$ 7,342	$ 6,902
Charges (credits) to income not requiring outlay of funds:		
Amortization of mortgage loan purchase discount	(6,947)	(2,589)
Commitment fees forfeited	(800)	-
Amortization of debt expense	1,004	430
Provision for portfolio losses	3,280	2,800
Provision for participation sale certificate guarantees	459	13
Funds provided from operations	4,258	7,556
Proceeds from bonds sold, net of debt expense	896,881	598,287
Proceeds from sale of participation sale certificates	409,820	65,024
Proceeds from sale of mortgages, net	-	48,368
Mortgage loan principal repayments	62,943	21,474
Decrease in cash and temporary cash investments	57,737	13,012
Other items, net	5,647	3,453
Total funds provided	$1,437,286	$757,174
FUNDS APPLIED:		
Mortgage loans purchased	$1,262,286	$757,174
Bonds retired	175,000	-
Total funds applied	$1,437,286	$757,174

The notes on pages 14 through 17 are an integral part of this statement.

FEDERAL HOME LOAN MORTGAGE CORPORATION

NOTES TO FINANCIAL STATEMENTS

DECEMBER 31, 1972

1. ACCOUNTING POLICIES

Discount on mortgages--Discount on mortgages purchased is recorded as income over the estimated life of the related mortgages (12 years) using the sum-of-the-digits method.

Allowance for possible losses on mortgage loans--The Corporation provides for estimated losses on mortgage loan purchases, including outstanding commitments, which may be incurred upon funding through a security sale or upon sale of the loans, and provides allowances for uninsured losses and contingencies.

Amortization of debt expense--Debt expense is amortized over the period during which the related debt instrument is outstanding.

Commitment fees--Commitment fees are deferred and (a) credited to discount on mortgages as the mortgages are purchased or (b) credited to other income when forfeited by nondelivery.

Recognition of income (loss) upon sale of participations in mortgages--Interests are sold in mortgages or participations in mortgages where the certificate yield payable to the investor may be more or less than the net yield to the Corporation. Where a loss is indicated, the total loss is recognized at the time of sale. Gains, representing the excess of net yield to the Corporation over that payable to the investor, are recognized as earned over the lives of the related mortgages.

Reserve for guarantees--Certain sales of interests in mortgage loans include the Corporation's guarantee of the related mortgages. The Corporation provides for these guarantees on the same basis as income or loss is recognized, as explained above.

2. BONDS AND ADVANCES PAYABLE

As of December 31, 1971 and 1972, the bonds and advances payable consisted of:

	Maturity	Interest rate	Amount 1971	Amount 1972
			(millions)	
Mortgage-backed bonds	Nov. 27, 1972	7.10	$175	$ -
	Nov. 26, 1973	6.70	150	150
	Aug. 26, 1974	5.30	-	200
	Feb. 25, 1977	6.15	-	350
	Jan. 12, 1979	5.63	-	26
	Jan. 12, 1979	6.14	-	77
	May 1, 1980	5.13	-	22
	May 15, 1980	5.19	-	22
	July 1, 1980	5.68	-	48
	Nov. 1, 1985	5.37	-	3
	Nov. 27, 1995	8.60	140	140
	Aug. 26, 1996	7.75	150	150
	May 26, 1997	7.15	-	150
			615	1,338
Advance from Federal home loan bank in the form of pass-through of consolidated Federal home loan bank obligations	May 27, 1974	6.35	200	200
	May 25, 1977	6.95	100	100
Total			$915	$1,638

The 1997, 1995, and 1996 mortgage-backed bonds are redeemable at the Corporation's option commencing 1982, 1983, and 1984, respectively, at their face value. On the 1995 and 1996 bonds, a sinking fund provides for annual retirements of $7 million and $7.5 million principal amount of bonds, respectively, commencing in 1976 and 1977. In addition, the Corporation has a noncumulative option to increase the sinking fund amounts each year by an amount not exceeding the annual retirement amounts.

GNMA guarantees the principal and interest of all mortgage-backed bonds. Under the provisions of a trust indenture with GNMA dated October 26, 1970, and supplements thereto, the Corporation conveyed mortgages to the trust as security for the mortgage-backed bonds. As of December 31, 1972, trust assets of approximately $1,368 million constituting primarily principal balances of such mortgages are restricted for the payment of principal and interest on the mortgage-backed bonds and are included in the balance sheet (sch. 1).

3. COMMITMENTS

As of December 31, 1971 and 1972, the Corporation had outstanding commitments to purchase mortgage loans as summarized below. The average effective net yield is computed after deducting servicing fees. FHA and VA mortgage purchase commitments are at varying fixed purchase prices and the yield is based on a coupon rate of 7 percent and assumed average life of 12 years.

Type of loans	Delivery period	Average effective net yield	Amount
	(months)	(percent)	(millions)
December 31, 1971:			
FHA or VA home (1 to 4 family)	6	7.48	$164
	12	7.16	2
	18	7.24	3
Participation in conventional mortgages--home and multifamily combination	1	7.625	14
Total			$183
December 31, 1972:			
FHA or VA home (1 to 4 family)	6	7.44	$ 2
	2	7.29	28
Participation in conventional mortgages--home and multifamily combination	1	7.50	116
Conventional mortgages:			
Home	2	7.37	48
Multifamily	24	8.21	4
Total			$198

4. PARTICIPATION SALE CERTIFICATES

The Corporation sells participations (undivided interests) in mortgage loans evidenced by the issuance of participation sale certificates. The certificates are guaranteed by the Corporation as to the timely payment of interest and the collection of principal. Unpaid balances of the outstanding participation sale certificates were approximately

$65 million at December 31, 1971, and $444 million at December 31, 1972.

The certificates issued have been accounted for as sales by the Corporation. Accordingly, the mortgage loans and liability for the certificates issued are not included in the accompanying balance sheet.

REGIONAL OFFICES

Region	Location
1	Boston, Massachusetts
2	New York, New York
3	Pittsburgh, Pennsylvania
4	Atlanta, Georgia
5	Cincinnati, Ohio
6	Indianapolis, Indiana
7	Chicago, Illinois
8	Des Moines, Iowa
9	Little Rock, Arkansas
10	Topeka, Kansas
11	Los Angeles, California
12	Seattle, Washington

PRINCIPAL OFFICIALS

	Tenure of office	
	From	To
BOARD OF DIRECTORS:		
Thomas R. Bomar, Chairman (note a)	June 1973	Present
Carl O. Kamp, Jr. (note b)	July 1970	Present
Grady Perry, Jr.	July 1973	Present
Preston Martin	July 1970	Nov. 1972
Thomas Hal Clarke	July 1970	July 1973
PRESIDENT:		
William J. Popejoy	June 1973	Present

[a] Before June 1973, Mr. Bomar served as the top executive officer of the Corporation with the official title of Executive Vice President.

[b] From December 1, 1972, to June 1973 Mr. Kamp served as Acting Chairman.

Copies of this report are available at a cost of $1 from the U.S. General Accounting Office, Room 6417, 441 G Street, N.W., Washington, D.C. 20548. Orders should be accompanied by a check or money order. Please do not send cash.

When ordering a GAO report please use the B-Number, Date and Title, if available, to expedite filling your order.

Copies of GAO reports are provided without charge to Members of Congress, congressional committee staff members, Government officials, news media, college libraries, faculty members and students.

AN EQUAL OPPORTUNITY EMPLOYER

UNITED STATES
GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE,$300

POSTAGE AND FEES PAID
U. S. GENERAL ACCOUNTING OFFICE

U.S.MAIL

THIRD CLASS